RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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January 13, 1982 **LETTER 826**

Dec. 31, DJIA 875.80; PTI 1414; A-D Ratio –23.57
Jan. 8, DJIA 866.53; PTI 1404; A-D Ratio –23.97

THE PICTURE: From mid-December to early-January the D-J Averages provided a textbook example of divergence. The Industrial Average trended to the upside while the Transportation Average declined. When the two Averages "disagree," it is usually an indication of distribution, and the December-January instance certainly suggests that stocks were being distributed under the guise of "hopeful" Industrial action.

The new year opened (January 4) with a one-day rally. The second trading day of 1982 (January 5) saw the market break badly. On that day Transports tumbled to their lowest level since October. Industrials, on January 5, dropped decisively below their December low of 868.25. In the past when the December lows have been broken any time in January, it has been a bad omen for the market. For the December low to have been violated on only the second trading day of the new year strikes me as particularly ominous – the kind of action I would associate with a powerful bear market.

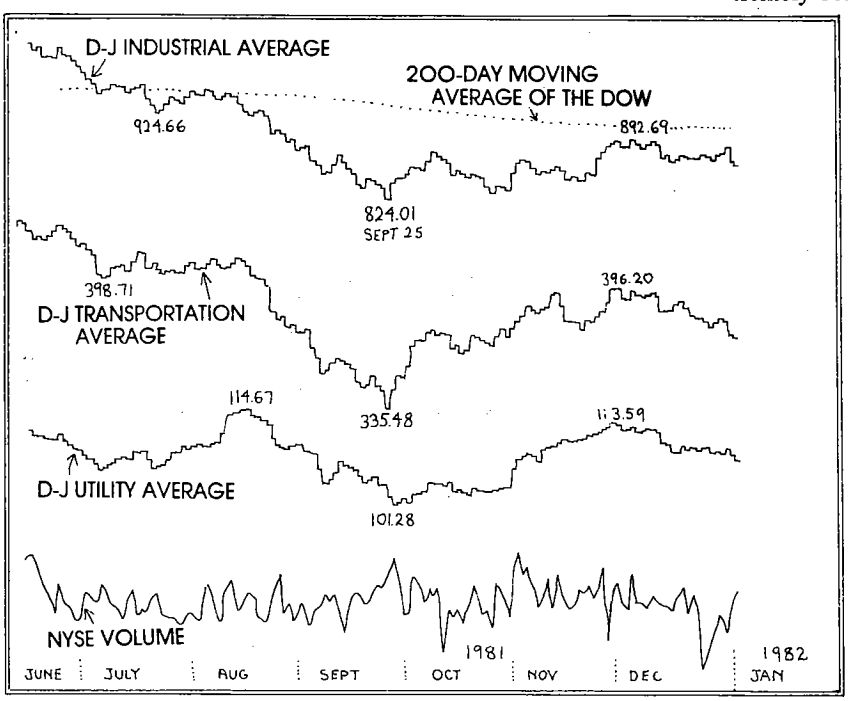
It should be remembered, however, that the Averages are still in "secondary territory," that territory below the last highs but above the preceding lows. While in secondary territory (I often term this "no-man's land") the market can be unusually deceptive and hard to follow.

From a Dow Theory standpoint two items are of note: (1) The primary trend is taken to remain in force until proved otherwise. The last primary signal was bearish; therefore the main trend of the market is taken to be DOWN. (2) The principle points to watch now are the September 25 lows – 824.01 for Industrials and 335.48 for Transports. If these two points are violated, the Averages will have signaled a re-confirmation of the primary bear trend. Incidentally, the September lows are so critical that in my opinion if these two points are broken we can expect something akin to a crash in common stocks.

FRONT PAGE COMMENT: On January 4 exponents of the "hyper-inflation" thesis got a preview of why hyper-inflation may never occur. On January 4 the Fed announced that the M1-B money supply jumped an unexpected $1.4 billion. On this news the bond market swooned, with many long-term Treasury bonds dropping 1 to 2 points ($20 per $1000). As I've said before, money watchers have become very knowledgeable and very sophisticated. At the first hint of anything like hyper-inflation I would say that we would see a wide-open crash in the bond market. Such a crash would send interest rates through the roof and the stock market through the floor. In this kind of atmosphere, hyperinflation is impossible.

My friends at Weiss Research down in W. Palm Beach, Florida, put it another way, but they are saying the same thing: "Now we have the most powerful anti-inflation 'lobby' of all time. They are the nervous holders of $5.2 trillion in bonds, loans, and mortgages. These are citizens who need not wait for the next election, nor do they need to bang on the desk of some faceless bureaucrat. All they have to do is pick up the phone, call their dealer and say, "Sell."

In the last two Letters I listed many items which I felt underscored the bearish case for this market. I want to repeat again that the price-breadth situation on the AMEX is one of the most bearish that I have seen in many years. The A-D line on the AMEX has now plunged below not only its September, 1981 low but below its entire 1980 range. In the face of this the AMEX stock Average attempted to rally. This kind of price-breadth divergence – with breadth leading on the downside – is extremely bearish.



Moving over to the NYSE note (Page 2 chart) that the A-D ratio on the NYSE has traced out a "toppy" looking structure. At present the A-D ratio is less than a point above its September 25 low of minus 25.22. The A-D is telling us that at present almost all of the NYSE gains since early 1980 have been wiped out. A drop below the September lows would be taken as extremely bearish.

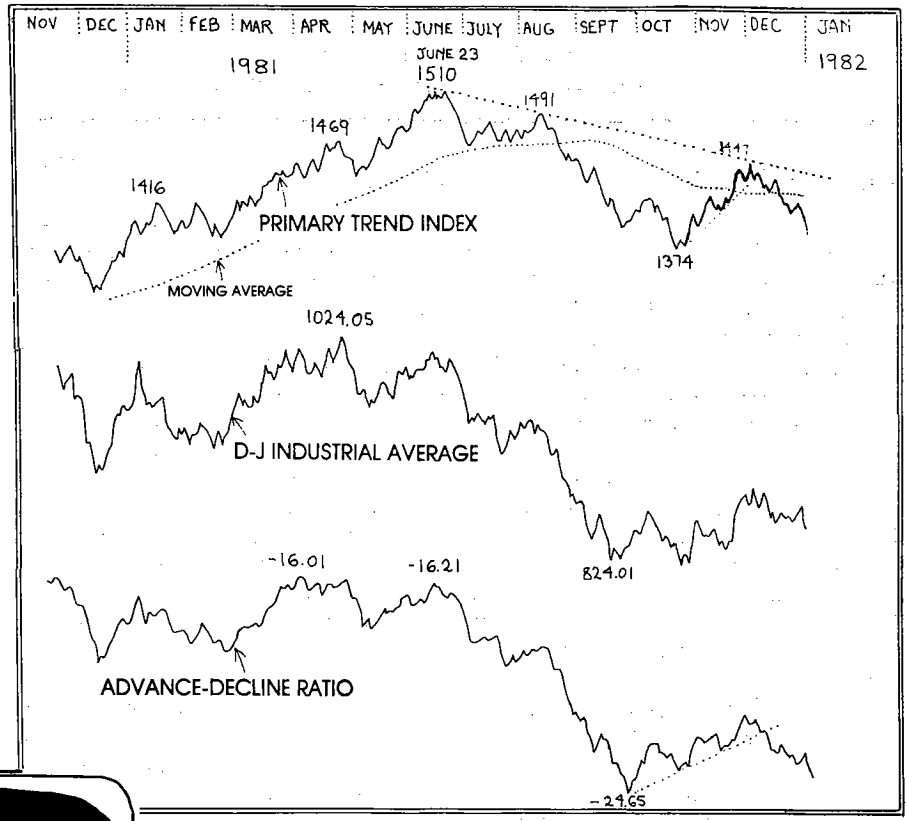
The Primary Trend Index (PTI) is our next subject (chart Page 2). For the benefit of new subscribers I should state that the PTI is my own invention, a proprietary indicator which is, in reality, an amalgam of eight averages and indices. Older subscribers know that the PTI has been invaluable in keeping us on the right side of the stock market.

As discussed in the last Letter, the PTI is currently bearish as to its minor, secondary and primary trends. But over the last few months the PTI has

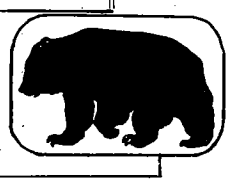
charted a course which I consider particularly negative. Here is what I see.

The PTI formed a major top during April to August of 1981. During September and October the PTI broke below that top, falling to 1374 on October 26. A new rally got underway during October-November. But note that during November-December a SECOND TOP was formed with a peak at 1447. This secondary top (a second distribution area) forming *below* the first top is part of an overall structure which I have found to be extremely bearish. In December the PTI dropped below its second top, and as this is written the PTI is roughly 25 points above its 1374 low. A violation of 1374 would complete the entire massive distributive formation, and would (in my opinion) trigger the PTI and the stock market on an extended new down-leg.

Note on the chart that the PTI is traveling below its 21-day moving average, and the moving average is turning down again. I would say that the odds are high that the PTI will test its 1374 low within the next month.



INVESTMENT POSITION: The bear at right says it all. Our investment position is Treasury bills, and we "roll 'em over" every 91-days.



A LOOK AHEAD: Well, 1982 is here, Russell, and what do you see ahead?

Answer: the consensus is that the economy "will turn up" around the second to third quarter 1982. This may happen, but as a contrary opinion my guess is that the economy will either turn up early in the year (which I doubt) or there won't be any significant turn-up at all in 1982.

However, and this is important, when the upturn finally does arrive I don't think it's going to be the time-honored kind of expansion that we're used to. Any rise is going to be labored, spotty and probably short-lived. Here is what I see ahead.

The US Government is strapped for money – unbelievably strapped. MOST of the budget money is going to go to the military or to Social Security and other entitlement programs. A good deal of the money that has been going to the states, municipalities and cities is going to be cut off. As that occurs, the various states and cities will turn to the municipal bond market in an attempt to raise new cash.

Special to The Christian Science Monitor
Boston

Instead of plying the waters off Antarctica next year conducting underwater experiments, the 200-foot research ship Atlantis II will remain moored at the Woods Hole Oceanographic Institution on Cape Cod, enduring only the wavelets that lap at its hull.

Scientific research may be "the foundation of progress," but cracks are starting to show in its supports. Huge federal deficits have forced government laboratories and private institutions that receive federal grants to share the cost of budget reductions.

But the usual buyers of muni bonds, the insurance companies and casualty companies, are buying very few bonds these days, and as a result the market for muni's has dried up. Prices of muni's are at historic lows. For this reason many recent muni issues have been cancelled or withdrawn. This is going to mean a general trend toward *less local government and less employment* by local governments. In fact, in 1981 for the first time in 34 years government employment went down. There are now about 300, 000 less employed by the various governments (Federal, state, city) than there were in 1980.

Question: OK, so you see less government employment. But what is going to happen to the typical citizen?

Answer: Mr. Citizen is going to face a squeeze, probably a slow squeeze. His costs are going to keep going up, and I'm talking about utility costs, interest costs, school costs, medical, taxes, etc. That means less to spend and it means that it's going to be very hard to save. Consequently, we're going to see a lot of the frills being hit. By frills I mean restaurants, movies, expensive vacations, boats, luxury cars, that sort of thing. I think we're going to find the high school and college kids become a lot more job-conscious and we're going to find that the uneducated kids (particularly the minorities) will become even more discouraged. In general it's going to dawn on America that the era of "a million free lunches" is over. There will be a lot less handouts – the money just isn't there to hand out anymore.

Question: How will this affect the markets?

Answer: I see the stock market in a long-term secular downtrend. Business is going to become more competitive – rougher. New industries will spring up – such as home computers. But look – already the home computer industry has become extremely competitive. In fact, home computers, which are fated to be a huge

industry, are nearing the dog-eat-dog stage, and the Japanese haven't even gotten into the software end of it yet.

With long-term rates holding generally high, the stock market is going to have a kind of "yield ceiling" put over it. After all, when you can get your money back in six to eight years in bonds, that's rough competition for stocks. So although there will always be individual winners in the stock market, the chances of a major, spectacular bull market are slim – that is, they are slim until we can get rid of some of this mountain of debt.

Question: How do you propose to get rid of the debt?

Answer: I don't have any personal solution. The markets get rid of the debt – the time honored way, through depression and bankruptcy. The longer a depression is held off, the stickier and sicklier the situation is going to become. Of course, the Fed could move to hyper-inflation via monetization of billions of dollars of new debt – but if they do that the bond markets will utterly collapse and interest rates will go through the roof.

Question: All right, what about interest rates?

Answer: Interest rates are a function of supply and demand in the money markets; they are also a function of the inflation rate, and they are a function of safety (or how safe bond buyers think the debt is). The way we're going, interest can only come down very temporarily, but long-term rates are going to *stay high*. What we're seeing is a transfer of new debt from the corporations, the states, municipalities and cities – to the Federal Government! As Government needs rise, everybody else will be pushed out of the debt markets. The alternatives to rises in Federal debt are (1) lowering Federal spending, which the Government is not doing, (2) raising taxes, which we are probably going to see, (3) inflation, which gives the illusion of lowering the debt by making all dollar debt worth less. I don't see the Government following any of these courses consistently, although they will try one or all of them at different times.

Question: So what does this add up to, Russell?

Answer: Many say we're on the downward side of the Kondratief wave cycle. I am not an avid exponent of this cycle, but I do think that we've passed the point of no return on the upside. Therefore, I see the American economy as being subject to a "set of brakes." Now whether these brakes will simply bear down on the economy over say the next 10 years, or whether they will bring the economy to a screeching halt in a year or so I can't say. But there is no doubt in my mind – THE BRAKES ARE ON.

Question: What do we, as investors (or survivors if you wish), do in this situation?

Answer: Times and situations change, they are fluid. *There is no long-term answer.* Right now I like T-bills. If the market starts looking better I may suggest some trading. If the market smashes here in 1982, I will almost certainly be looking for an outstanding buy spot for stocks. So far, the stock market looks soggy. And that means that I prefer staying with the T-bills. The bills are paying over 11%, they are providing a real rate of return (over inflation). I'm feeling no pain at all staying with T-bills. So we sit, relax, and await developments.

Question: I note that interest rates have come down some since the 1981 highs. Isn't this a hopeful sign?

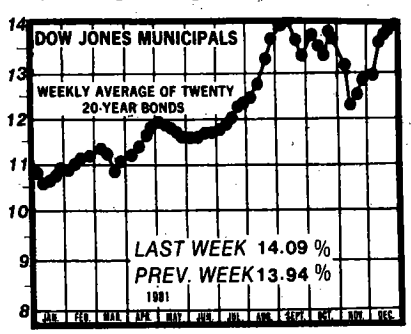
Answer: You know, I read all the blather about interest rates, and I wonder if we aren't witnessing a case of mass hypnosis on Wall Street. Everybody and his brother is talking "as if" interest rates are coming steadily down. But despite the hopes and wishes, the FACT is that Treasury bills and most Treasury obligations hit their low on December 4, and rates have been CLIMBING since!

The FACT is that the low for T-bills was 9.9% (yield) recorded on December 4, and the current rate is 11.6%. Now honestly, that doesn't indicate that rates are going down (as the economists would have you believe), does it? With a trillion dollar debt, with deficits predicted to add up to $440 billion over the next three years, this recession is probably going to be the first recession in American history that sees interest rates *stay* high – and go *higher*. The reason – a continuing acute NEED for cash, a need based on *illiquidity* and massive requirements for servicing debt.

I'll repeat again, the TOTAL debt in the US is currently 5 trillion dollars. At approximately 10% rates of interest, it is costing the nation roughly 500 billion a year to carry this unbelievable debt. When a recession hits, earnings and profits go down and less cash is generated. But the interest on the 5 trillion in debt *remains – it still must be paid!* Result: a continuing pressing need for cash. And this means that interest rates cannot collapse as before.

In the money markets, this has created a heads you lose, tails you lose situation. If the economy continues to slump, interest rates will stay on the high side as now. If the economy turns up, interest rates will head up as the need for new borrowing develops.

In the longer-term bond market (and unlike the short-term market, the bond market cannot be manipulated) the Treasuries are already pushing to yields above 14%. The D-J 20-Bond Average has now given back two-thirds of its rally gains, and the yield on the D-J 20-Bonds is now 14.90%. In the municipal area we find the D-J Municipal Bond Average yielding a record 14.09%. Devastation is the only fitting description for the muni's.



It is also important to realize that the average yield on municipal bonds is now 93% of the yield on Treasury bonds. The normal percentage is about 75%. Thus, with muni yields in many cases equalling Treasury yields it appears that T-bonds are priced too high, and such pressure should force T-bonds down (and send T-bond interest rates even higher than the current 13.75% to 14.00%.

The terrific pressure on all forms of investments can be understood by this example. You can buy a municipal bond from your own state yielding say 13%. This bond is free of ALL state and

federal taxes. At 13% compounded, your money will double in less than six years.

Why are the muni's so cheap? (1) The general fear that anything less than a US Treasury obligation is risky. (2) The fear that a money crunch lies on the horizon, and such a crunch would hit ALL longer term bonds. (3) The drop in the peak taxing rate (starting in 1982) for unearned income from 70% to 50%, thereby making non-taxable income somewhat less attractive.

Nevertheless, and I've thought about this at length, in the event of a credit crunch and a renewed collapse in the bond market, many high-grade muni's (particularly those from your own state) would be awfully attractive. For the sake of argument, suppose high-grade muni's went to 17% yield. At that yield you would have your total investment back in tax-free interest in just over four years! That kind of play is well nigh irresistible. The only catch could be a credit collapse in which a good portion of the US (including many states and municipalities) might become insolvent.

Question: All right, Russell, what are the chances of a collapse in which states, cities, and municipalities go broke?

Answer: Despite much pious nonsense and many token gestures, the Federal Government, the states and the cities have utterly failed to take the steps necessary to avoid a fiscal crisis. I've said it before and I'll say it again, politicians WILL NOT MOVE until the crisis actually bursts over them. Therefore, I don't expect, and I never have expected, any serious attempts to deal with the budget deficits – until we are faced with the reality of a national fiscal and monetary emergency.

The fact that Social Security is going broke has not led to any real cut-backs in SS. The fact that the national budget is running wild has not led any President or Congress to take the harsh steps needed to balance the budget. The fact that military spending is roaring into space has not led to an amalgamation of the three services and a massive cost-cutting approach. No, nothing will happen, no action will take place, until the fiscal mess hits the fan! When that occurs the nation will be FORCED to take action. There will be no choice except drastic, wholesale budget cuts, general bankruptcy or a moratorium and restructuring of all debt.

The debt that would stand up best in such a situation would probably be the shortest term obligations of the US Government. That is why T-bills are the preferred investment now. If one is willing to take risks the potential rewards increase. And one of the rewarding areas could be the muni's. But we will have to get closer to the situation before we can make an intelligent judgment. As of now, the fiscal mess is moving ever closer to the fan – but it has not hit – yet.

NOTES & QUOTES: Just when it looks as if New York City was solvent, along comes 1982 and the prospect of an $800,000,000 deficit. A second major NYC problem is that its physical plant is falling apart. The streets and parkways are pocked with holes, the sewer system is in disorder and the subways are in shambles, It is estimated that it would cost over $2 billion just to bring the subways back to snuff.

One of the problems of NYC is poverty. One out of every four children in the city will be on welfare at some time. There are currently 600,000 NY children on the welfare roles.

In the face of this, I just talked to an interior decorator from NYC. She talked angrily about the difficulty of getting people to work and get things done in the City. She said prices (despite the recession) are sky-high for construction and repair jobs in New York. She said, "Welfare is the worst thing that ever happened to this country. I can't get people to work, they don't give a damn. And if they do work, they usually aren't skilled enough to do the job right. Often, some guy will quit in the middle of a job because he's offered another fat-paying job that he can't resist. As far as skilled people like tile layers or cabinet builders, I find them so expensive and arrogant that sometimes I really wish there was a depression. Maybe that would put the fear of God into some of these (unmentionable word)."

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A few weeks ago I examined one of the new De Lorean cars carefully. My opinion – unimpressive. I don't see how this car is possibly going to compete with Porsche or the new Japanese sports cars. Then a few weeks ago I received *New Issues* (3471 N. Federal Highway, Ft. Lauderdale, FL 33306) and it contained a most unique writeup of *De Lorean Motors Holding Co.* De Lorean hopes to stay alive by floating stock. The original issue was 2.2 million shares at $10 to $14 a share. The offering is now revised to 1 million issues at $12 to come out early in 1982. De Lorean is short of cash and unable to pay current obligations. The company survives, says *New Issues*, "only through the indulgence of its bankers" and the government of Northern Ireland. Then *New Issues* suggests a rather unique concept (I couldn't tell if they were serious). The De Lorean may have value as a collector's item. So you buy a De Lorean car plus some of the new stock issue. "If the company survives and ultimately prospers, your stock should do well. If it doesn't, perhaps the appreciation in value of the car will more than offset your loss. Either way, you'll own a cute little car."

* *

From our "Signs of the Times" Dept: I got a call from my old buddy, Jay Pack, out of New York City last week. "I was down at Times Square the other night," he said, "and I looked up, and it was amazing. I thought I was in Tokyo. Huge signs in all directions all advertising Japanese products. I wish I had a picture of it to send you." "Yeah," I replied, "It's Japan's revenge for losing World War II."

* *

Despite dire warnings by the air controllers union, US airlines have now gone 26 months without a fatal accident. This is one of the longer spans in US history, and it is 8 months longer than the preceding cycle. All of which underscores Russell's Law which states that efficiency in government is an inverse function of the number of people government employs (ie., the fewer employees, the better our government works). In fact, if our government could be REDUCED to just the armed forces, the police and the courts the nation would probably rise to world leadership again.

* *

I don't know how many of you saw the Miami-San Diego pro-football play-off game. The Miami Herald called it the "greatest NFL game in history," and the LA Times commented that it would probably be remembered long after the 1982 Super Bowl game was forgotten. For sheer white-knuckle suspense and drama, I've never seen another game like it. After the game I mused as to why a football game should so grip the entire nation. The answer, I think, is that a game is something that can be solved – it has a true (often heroic) ending. Unlike politics or economics in which the "ultimate solution" never arrives, a football game does end. There is a winner and a loser. And that alone is a relief in a world that seems to produce more unsolvable problems as the years go by.

Speaking of football, one of the most amazing series of coincidences concerns the market and the Superbowl. Since 1967's first Superbowl, every year in which the NFL has won the market has advanced. Conversely, every year in which an original AFL team has won, the market has declined. The sole exception was 1978 when Dallas won but the Dow declined 31 points or a mere 3%. Thus the record is 94% correct. Is there an analyst in the world who has beaten that record! If you're a bull this year, hope for San Francisco to win the Super Bowl. If you're a bear you're rooting for Cincinatti.

Year		DJI
1967	Green Bay (N)	Up
1968	Green Bay (N)	Up
1969	NY Jets (A)	Down
1970	Kansas City (A)	Down
1971	Baltimore (N)	Up
1972	Dallas (N)	Up
1973	Miami (A)	Down
1974	Miami (A)	Down
1975	Pittsburgh (N)	Up
1976	Pittsburgh (N)	Up
1977	Oakland (A)	Down
1978	Dallas (N)	Down
1979	Dallas (N)	Up
1980	Pittsburgh (N)	Up
1981	Oakland (A)	Down
1982	?	?

* *

The Idiots Corner: Having paid out $186 million in dividends recently, GM has now moved to borrow $500 million by refinancing its Manhattan property. Keep it up GM, with slumping car sales and continued dividend payouts and additional borrowing, you may be our biggest bankruptcy yet.

By RANDALL SMITH
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK–General Motors Corp. said it raised $500 million cash in an unorthodox financing tied to the eventual sale of its white marble office tower on Fifth Avenue in Manhattan.

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From our "This Is Good News?" Dept: Our stalwart defender of the currency, Treasury Secretary Regan, announced on the *Today* show that the 1982 and 1983 budget deficits will be under $100 billion. Gee that's good news!

By CHRISTOPHER CONTE
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON–President Reagan will propose budgets with deficits narrower than $100 billion for the next two fiscal years, Treasury Secretary Donald Regan predicted.

* *

Since the 1973 oil embargo, demand for energy has dropped by an average of 2.3% a year. Furthermore, 700,000 barrels of daily oil production are being added each year, and non-petroleum sources of energy – including hydropower, nuclear, coal and natural gas – are increasing at an annual rate of 4%. In the face of this, OPEC has been fighting to prevent a major crack in the price of oil. Saudi Arabia has already cut production from 10.5 to 8.5 barrels of oil a day, and estimates are that the Saudis could cut to 6 million barrels if they wanted to bolster the price. Nevertheless, discounts in the current $34 per barrel are now common and the big guessing game in world energy is – will the oil price hold or will it break up to $5 in the world market? The implications of a world oil price decline are obviously crucial.

From a friend (an oil analyst-broker) out of Denver: "Richard, I'm telling you, if the oil price should happen to come down to say $23-24 a barrel, you'd see the biggest bank panic you can imagine. Why? The banks have lent billions, I mean zillions to the oil companies. If the oil price structure doesn't hold, you're going to see those bankers out on the window ledges!"

* *

I want to end this first Letter of 1982 on an upbeat note. So here it is. What this means is that roughly one out of every 63,000 people made a million bucks last year. On second thought, those aren't very good odds, are they?

A total of 3,542 Americans filed tax returns last year claiming their gross adjusted income was $1 million or more.

The number of millionaires who filed tax returns was up a total of 69 percent over the number who filed the previous year, according to figures from the Internal Revenue Service.

As a group, they paid $4 billion in taxes on $7.8 billion in income — which means Uncle Sam took a whopping 51 percent.

* *

GOLD: On January 7 three gold or gold-related shares hit the new low list on the NYSE – Dome, Homestake and Newmont. This does not bode well for gold, at least over the short term. The metal itself has been scraping along in the 395-405 range, and I must say the gold action gives the appearance of some kind of manipulative support around the 400 range. The Russians have been large sellers of gold, and it is certainly possible that they have been supporting the metal around the 395 level.

The major argument for holding gold is this: The world is awash in a sea of debt. Outstanding debt to the West is $600 billion. Ten years ago it was $93 billion. Poland is now in trouble, and there is a possibility that a good deal of the Communist debt will some day be flushed down the drain. On top of this a severe economic recession has hit the West. At some point, this recession could get out of hand on the downside. People will then start terming it a depression. That could set off a paper blizzard as the West attempts to inflate itself out of the depression. The amount of paper money needed to even begin to turn the tide would be massive, and such action could raise acute doubts about the wisdom of holding paper money. That kind of environment would trigger a concerted move by frightened paper money holders into gold.

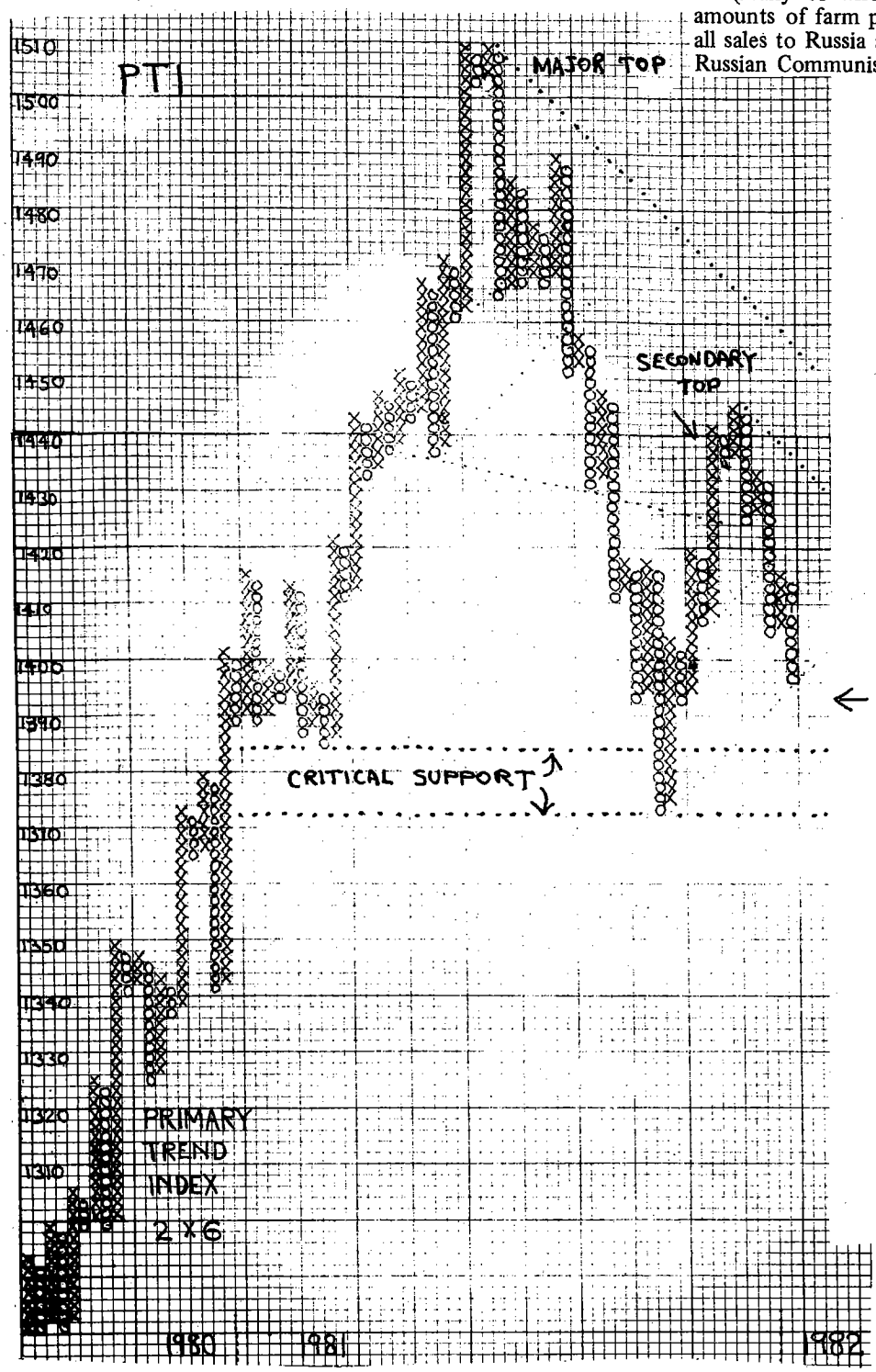
The question: should we jump the gun and start buying gold now? In my considered opinion, the answer is "no." I have advocated (and I hold myself) a survival position in gold coins. But as for taking a big gold position, I am holding off. On my point & figure chart, I am watching two levels. A preliminary upside breakout for gold would come at 428. A much, much more significant breakout would come at 464. Personally, I am

willing to wait for 464 before taking a major position. Short of 464, I'm going to sit, watch and wait. The way things are going there still could be a big rush for dollars. Dollars could, in fact, become scarce for you and me. Why scarce? Because the US Government is going to grab, absorb, confiscate, swallow up or tax away every dollar it can get hold of. With deficits in the hundreds of billions of dollars on the way, the Government has become (like the great white shark) an eating machine, and its food is money.

THOUGHT FOR '82: The value of all publicly issued common stock in America is roughly $1.572 trillion. That is about the amount that the US Government has slated for military spending over the next five years. Military spending is non-productive; it produces nothing in the way of a nation's wealth. Thus, an amount comparable to the public corporate wealth of America will be spent for the military between now and 1986.

SECOND THOUGHT: Western bankers have literally financed the rise of Communism. Poland alone owes the West about $30 billion. The value of Western sales to Russia is about $15 billion a year. A good portion of this is Western high technology. US farmers (many of whom profess to be "conservative") sell massive amounts of farm produce to Russia. In short, if the West halted all sales to Russia and her satellites it is probable that the whole Russian Communist axis would collapse. But not to worry, that will never happen. Greed conquers all, and before it's all over GREED may well conquer the West.

LATE NOTES: With the break-up of American Telephone, the dropping of the anti-trust suit against IBM and the US Steel takeover of Marathon, the DJIA is bound to be affected. But the adjustment will be made quickly, and it should be remembered that these kind of events do not turn the tide of American business. When the adjustments are made, the market will go the way it was going to go prior to the news. In fact, a bear market will use temporary bad news as a guise for accumulation.



← **SPECIAL STUDY:** I finally came up with some extra space in this report, and I have been wanting to include my 2 x 6 point & figure chart of the PTI – so here it is. You can see the major top that formed in the PTI during 1981. Now note the more recent structure, a pattern that appears to be a second smaller top. Another way of looking at the whole picture is that of a head-and-shoulders top with the most recent rally forming the right shoulder of the head-and-shoulder top.

Either way it is clear that the 1981 low of 1374 is a critical point. A break below 1374 would throw the whole structure powerfully to the downside and suggest vastly lower values for the PTI – with accompanying sliding prices for the general maket. Remember, a steady and persistent trend in the PTI will, in due time, take the market and most stocks with it.

NEXT MAILING: Jan. 27